No. 89-[illegible]

In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

JOINT BRIEF FOR THE RESPONDENTS

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Question Presented

Whether the Internal Revenue Service may be required to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability.

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 89-255

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NEWPORT OFFSHORE, LTD.

JOINT BRIEF FOR THE RESPONDENTS

Summary of Argument

The consolidated cases before this Court raise the question of whether a Chapter 11 corporate debtor, following the successful confirmation of its plan of reorganization, may designate the allocation of its post-confirmation payments of tax indebtedness to the Internal Revenue Service first to the trust fund portion of the corporation's tax liability, thereby reducing

both its own liability in respect to certain designated taxes as well as the liability of the corporation's "responsible persons" in respect to the same taxes.

In its belief that it is following the common law, the Petitioner (hereinafter "Government" or "IRS") has evolved a policy of allowing taxpayers to designate how "voluntary" payments should be allocated among their tax liabilities. It has, however, reserved to itself the privilege of such allocation when it deems such payments to be "involuntary." In the Chapter 11 context this voluntary-involuntary dichotomy has been frequently litigated. The IRS believes that Section 6672 of the Internal Revenue Code, which imposes upon a corporation's "responsible persons" liability for the corporation's unpaid trust fund taxes, should have a significant penal and deterrent effect. Accordingly, it has taken the position that all tax payments pursuant to a Chapter 11 plan are involuntary, that no power lies in the bankruptcy court to require allocation of the tax payments and that to impose an allocation upon it would impair an overriding federal tax policy of maximizing the total collection of tax revenues.

Both the Government's perception of the common law, as well as its application of the more recently evolved "voluntary-involuntary dichotomy," are in error and, as a result, it is both historically sound and logically appropriate that corporate taxpayers be able to designate the allocation of tax payments made pursuant to confirmed Chapter 11 plans. At common law debtors are free to designate the debts to which their payments should apply when the payments reflect the exercise of control by the payors over the funds paid. Conversely, creditors are free to designate the allocation only if the funds come into their possession without a prior designation or as a result of enforcement action that involves no prior judicial control (i.e. the court as "payor") over the funds. Where a

Chapter 11 debtor makes payments of its own funds, free from actual judicial control, subject to the revesting provisions of 11 U.S.C. § 1141(b) and following confirmation of its plan of reorganization, it has exercised a degree of control that is materially no different from the unfettered control, which the Government considers voluntary, exercised prior to the commencement of the Chapter 11 case; the Government's treatment of the funds received under such circumstances should be equally consistent.

Even if the appropriate common law test were the voluntary-involuntary dichotomy addressed in recent decisions discussed hereafter, the corporate taxpayer should be free to designate the allocation of all payments as it sees fit. First, the payments made incident to a confirmed Chapter 11 plan deserve to be deemed voluntary as a matter of law. Under circumstances where the IRS's total involvement in a Chapter 11 case need not and usually does not extend beyond filing a proof of claim, an act which is not even necessary if the debtor has scheduled the tax indebtedness correctly, where the corporate debtor is doing no more than paying the same tax dollars it previously was obligated to pay but, if it so elects, over a period of time with interest arising from the added flexibility Chapter 11 affords it, and where the bankruptcy court is essentially performing the role of a monitor in what is largely a consensual process involving negotiations among the debtor and various creditor classes, the conclusion should inevitably follow that the payments are made with that degree of freedom that far more closely resembles the debtor's pre-filing behavior than the IRS seizure and levy activity that has been equated with involuntariness. Second, the IRS's dimly relevant revenue rulings and policy statement are entitled to no judicial deference in the application of the common law to the facts here and certainly do not carry the force of law. If the IRS believes that the per se rule set forth by Respondents materially impairs its

tax collection efforts, its remedy quite simply lies in the Congress where, as the First Circuit noted, at least one bill has been introduced to address this allocation issue in a way most satisfactory to the Government.

Assuming, alternatively, that the debtor's post-confirmation tax payments do not warrant being deemed voluntary under the common law (be it defined by IRS policies or otherwise), it nevertheless follows that the bankruptcy court, if it so elects, may designate the allocation of the payments. First, the Government's voluntary-involuntary dichotomy is fundamentally an incomplete recitation of the common law. The importance of a "voluntariness test" does not apply alone to the debtor's payment of the funds, as the IRS argues, but rather as well to the creditor's receipt of the funds, and once a judicial body has intervened and the funds have come within its control, both the debtor and creditor are subject to all of the court's decisions in respect to the funds to which it ministers justice. Because the Government's opposition to voluntariness here is rooted in its perception of extensive judicial involvement, then it follows that the IRS must be bound by the allocation determinations of the court which is in effect controlling the funds turned over to the creditors. Second, bankruptcy courts are courts of equity with broad common law and statutory powers, including those embraced by 11 U.S.C. § 105, and the exercise of that power in designating the allocation of tax payments is a natural, indeed essential, adjunct to not only a host of statutory sections relating to the treatment and determination of tax claims but also the very ability of the court to resolve conflicting interests in order to enable the debtor to preserve its going concern value and to structure a plan of reorganization confirmable under 11 U.S.C. § 1129. Indeed, this exercise of judicial power is recognized by the IRS in the policies set forth in the Internal Revenue Manual.

The discretionary test set forth in the First Circuit opinion appropriately balances competing policies of the bankruptcy and tax laws and, in particular, does no damage to the goals of Section 6672 of the Internal Revenue Code. While the IRS single-mindedly may desire to collect all taxes without regard to the impact on other creditors, the Bankruptcy Code and the goals of Chapter 11, to the contrary, reflect a community of interests and a wide array of adjustments to normal debtor-creditor relationships, including those of the tax authorities. These adjustments include, among others, the ability of a debtor in its plan to pay its priority taxes over a period of six years from date of assessment, 11 U.S.C. § 1129(a)(9), and the division statutorily created between tax claims afforded priority treatment and older, but otherwise enforceable tax claims afforded only general unsecured status, 11 U.S.C. § 507(a)(7). The Government's assertion of a *per se* rule in its favor is not only irreconcilable with clear statutory enactments within the Bankruptcy Code that limit the rights of tax authorities available in the absence of a bankruptcy, but also is irreconcilable with the specific Congressional mandate of Section 6672 that trust fund taxes be accorded a special status and collected as soon as possible to avoid the "double loss" identified by the IRS. The Government's dogmatic adherence to maximizing total tax revenues likewise impairs numerous motivations which would foster reorganization under Chapter 11, in contrast to a Chapter 7 liquidation under which, to the detriment of corporate general creditors, the "responsible persons" might receive the immediate benefit of more rapid payment of priority tax indebtedness. Finally, at a time when the "responsible persons" do not enjoy any shield from the IRS pursuing collection of the trust fund taxes from them, should it wish to do so, confirmation of any Chapter 11 plan must meet the standard set forth in 11 U.S.C. § 1129(a)(11), in respect to which the IRS may appear in objection, that every plan be feasible (i.e. that the tax payments over time likely will be made).

Argument

I. The Government Is Obligated to Honor a Corporate Debtor's Request that Its Priority Tax Payments Under a Confirmed Chapter 11 Plan Be Applied First to Trust Fund Tax Liability.

At issue herein is a taxpayer's right to designate how the tax payments it is making will be applied. This issue is sometimes framed as the question of whether the payments are "voluntary" or "involuntary." The parties agree that a taxpayer making a "voluntary" payment may designate the allocation of such payment among various taxes, penalties and interest. *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); Government Brief at 11, 19. The parties disagree both as to whether the payments involved herein are voluntary and upon the consequences if they are not.

A. *Tax payments made under a confirmed Chapter 11 plan are voluntary payments.*

The issue of whether tax payments under a confirmed Chapter 11 plan should be treated as voluntary can best be resolved by this Court by reference to common sense, in light of the considerable flexibility granted to debtors under Chapter 11 to determine the timing of tax payments. "Voluntariness" is not an amorphous concept. *In re The Franklin Press*, 52 Bankr. 151 (Bankr. S.D. Fla. 1985).

At the outset, it is important to realize that a tax payment is not "involuntary" for these purposes simply because the taxpayer is required by law to make it. That is always true. Outside of bankruptcy, as the IRS will agree (see Government Brief at 20), a taxpayer is considered to have made a voluntary payment even if the payment is made after the date the taxes are

due, after the taxpayer has received a notice of deficiency, after an assessment has been made by the IRS, and even after the taxpayer has received a notice and demand for payment from the IRS, so long as the payment is made prior to an actual levy on the taxpayer's assets.

The Government contends that tax payments made under a confirmed Chapter 11 plan of reorganization are involuntary because the Bankruptcy Code requires the full payment of the taxes within six years of their assessment as a condition of the reorganization. Government Brief at 21-22. Although the Government acknowledges that the debtor has "some degree of 'latitude' as to 'how and when the IRS will be paid'," it contends that such flexibility should not cause the payments to be considered "voluntary" because the debtor's options are limited to paying in less than the six years allowed by the Bankruptcy Code. *Id.*

In the Government's view, the critical fact is that "[o]nce there is a confirmed Chapter 11 plan of reorganization, the debtor does not have the option to decline to pay priority taxes." Government Brief at 21. But, if this were the touchstone of "involuntariness," then all tax payments would be involuntary since no taxpayer, in bankruptcy or out, has the right to simply decline to pay its taxes. In short, Congress' elevation of certain tax payments to a priority status in bankruptcy cases may reflect sound fiscal policy, but it adds nothing new to the characterization of such payments by a confirmed Chapter 11 debtor as voluntary or not.

The Government attempts to overcome this weakness in its reasoning by pointing to an element of coercion behind the tax payments. It points out that a Chapter 11 proceeding must be dismissed or converted into a Chapter 7 liquidation if a feasible reorganization plan cannot be developed, and it reasons from this that the debtor's tax payments "cannot reasonably be regarded as 'involuntary' " because "the corporate debtor's

payment . . . essentially is made under threat of liquidation." Government Brief at 22. In this, too, the Government's shot misses the mark, since in numerous other contexts the mere threat of enforced collection, even if imminent, does not cause a tax payment to be considered involuntary, even by the IRS itself. Thus, for example, a taxpayer that pays its taxes when the IRS threatens a levy or seizure is entitled to designate how the IRS must apply the payment.

A fundamental error in the Government's argument is that it ignores the fact that the Bankruptcy Code actually expands the debtor's options for paying its taxes and restricts the Government's right to collect the taxes involuntarily through seizures. The debtor's right to pay taxes as it chooses over a six-year period actually gives the debtor more options than it has in those situations outside of bankruptcy that the Government would concede are voluntary.

The pertinent distinction is not, as the Government contends, that Chapter 11 requires the relevant tax liabilities to be paid in full. That fact does not distinguish Chapter 11 tax payments from any other tax payments, even payments the Government concedes are voluntary. Instead, the key characteristic of an involuntary payment is the creditor's act of seizing or receiving the property from the debtor's possession, without the interjection of any volitional act by the debtor. This is what makes the payment involuntary. *See Muntwyler* v. *United States*, 703 F.2d at 1033 ("the distinction between a voluntary and involuntary payment . . . is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy."). The fact that a tax liability (or other debt) may be due and owing, delinquent, subject to interest and penalties, and subject to a demand for payment by the creditor or Government, as the Government will concede, will not make the debtor's payment of it involuntary.

Even the Government's emphasis on the "requirement" that it "file claims" (Government Brief at 23) is inaccurate and fundamentally irrelevant to the issue at law. First, there is no requirement that a creditor file a claim in a Chapter 11 case although it may wish to do so in its best interests. Second, a debtor is obligated to file a schedule of its liabilities (11 U.S.C. § 521(1)) and this must be done under oath (Bankruptcy Rule 1007 (b)(1)). Third, unless the indebtedness to the IRS is omitted or is scheduled as disputed, contingent or unliquidated, the IRS need not file anything and its proof of claim shall be deemed filed in the amount scheduled for all purposes relevant to the Chapter 11 case (11 U.S.C. § 1111(a); Bankruptcy Rule 3003(c)(2)), including entitlement to payment.

Thus, the issue here is whether a tax payment made pursuant to a confirmed plan of reorganization in a successful Chapter 11 proceeding is akin to a seizure of the taxpayer's assets by the IRS, or is more like a payment made by the taxpayer itself to the IRS.

A number of the courts that have addressed this issue have examined whether Chapter 11 plan payments are "involuntary." This analysis almost invariably begins with citation of the Tax Court's definition of "involuntary" in *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966): "An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." The analysis then proceeds to consideration of the following statement in the *Muntwyler* decision:

> "[t]he distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action

> or administrative action resulting in an actual *seizure* of property or money as in a levy."

703 F.2d at 1033. The *Muntwyler* court also took as guidance the common meaning of the term "involuntary": "We will not interpret 'involuntary' to mean something completely at odds with the normal understanding of the term. . . ." 703 F.2d at 1034. In another case a bankruptcy court analyzed the *Muntwyler* opinion decision as follows:

> "[A]t each point where the *Muntwyler* opinion discusses court action, including dicta about bankruptcy, it appears that what was contemplated was the kind of court action, such as a seizure or a liquidation, which leaves the taxpayer with no options with respect to the treatment of a claim by the IRS."

In re Gilley Consulting Engineers, Inc., 74 Bankr. 568, 570 (Bankr. N.D. Ga. 1987).

The conclusion that payments made by a Chapter 11 debtor are "voluntary" follows from a recognition of the framework established by the Bankruptcy Code within which the debtor operates. Chapter 11 contemplates an orderly process in which the debtor will reorganize its financial affairs and satisfy its creditors in an equitable and feasible manner. Except in cases of fraud or serious mismanagement, the debtor's current management is left in control of its business. 11 U.S.C. § 1104(a). The filing of the Chapter 11 petition invokes an automatic stay of creditors' collection activities, giving the debtor the breathing space it needs coherently to arrange its affairs. *See* S. Rep. No. 95-989, 95th Cong., 2d Sess. 49-51 (1978). The focus is on the debtor and what it can do for itself, if permitted the opportunity. Chapter 11 provides the respite from creditor pressures the debtor needs to organize its own affairs and,

indeed, to assure that the payment scheme that it works out is truly voluntary.

In the formulation of a plan, the emphasis is on agreement and acceptance, 11 U.S.C. § 362(a); *see* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 224 (1977). The debtor is given an exclusive period within which only it may file a reorganization plan. 11 U.S.C. § 1121(b). Once a plan is filed, it is the creditors in the first instance who decide whether to accept or reject the plan. In a departure from practice under the former Bankruptcy Act, the court's role in the initial step toward a plan is simply to assure that creditors have sufficient information to make an informed decision; the court does not rule on the content of the plan before sending it to creditors. 11 U.S.C. § 1125; H.R. Rep. No. 95-595, *supra*, at 226. While the Bankruptcy Code does set certain broad parameters for the treatment of claims, a topic discussed in more detail below, it provides in each instance that a creditor may accept a different treatment of its claim. 11 U.S.C. § 1123(a)(4); 11 U.S.C. § 1129(a)(7); 11 U.S.C. § 1129(a)(9). Only after the creditors have expressed their sentiments with respect to the plan does the court address its merits and, when it does so, the court's role is confined. Section 1129 *requires* the court to confirm the plan if the standards set forth therein are met. 11 U.S.C. § 1129(a)-(b).

The Government notes the specific provision in § 1129(a)(9)(C) that tax claims be paid within six years of the date of assessment. Government Brief at 21-22. This is one of several provisions in which Congress legislated favored treatment of certain claims, including those of post-petition suppliers, the debtor's employees, consumers who placed deposits, and U.S. fishermen. *See* § 1129(a)(9)(A)-(C); § 507(a). In contrast to the other such provisions, which require immediate payment in cash in full unless the creditors agree otherwise, § 1129(a)(9)(C) permits the debtor to structure its payments to the taxing authority *as it sees fit*, so long as the Government ultimately

receives the present value of its claim in no less than six years after assessment.

Far from being an onerous provision, the six-year stretch-out affords the Chapter 11 debtor greater latitude than that available to a non-debtor, from whom the IRS may and probably will demand immediate payment of delinquent taxes. The flexibility afforded by § 1129 gives the debtor even more freedom as to the timing, manner and amount of tax payments than it would have in making voluntary payments outside of bankruptcy. The Government has fewer options to enforce such payments and has been precluded from exercising the power it would otherwise have to collect the taxes from the debtor involuntarily. Thus, there is no logical reason to conclude that payments under a Chapter 11 plan are not "voluntary."

This "common sense" analysis of the voluntary nature of payments under a Chapter 11 plan, based on the rehabilitative purpose of the Bankruptcy Code and the ordinary meaning of the term "voluntary," was made correctly by both bankruptcy courts below and ratified in the Energy Resources case by the district court. The First Circuit did not conclude otherwise, though it accepted, evidently reluctantly, the IRS's conclusion that it may treat the payments as involuntary, but only "for purposes of its own rules," despite what the court of appeals recognized as "the strength of the arguments favoring a determination that [the] payments are voluntary."[1]

The wide latitude afforded the Chapter 11 debtor in when and how to structure payments to its creditors has also resolved

[1] As noted later, even this degree of deference by the First Circuit was unnecessary, since the IRS's policy is based upon nothing more than that agency's interpretation of common law principles outside of its area of expertise. In any event, the First Circuit's limited acceptance of the IRS's labeling of the payments as involuntary did not affect the result, since the court held that regardless of the label that the IRS attached to them for its own purposes, the bankruptcy court possessed the power to override the IRS and designate the application of the payments in furtherance of the plan of reorganization.

for other courts the question of whether plan payments are voluntary. In *In re Lifescape, Inc.*, 54 Bankr. 526, 528 (Bankr. D. Colo. 1985), the court adopted the rationale set forth in *In re A & B Heating and Air Conditioning, Inc.*, 53 Bankr. 54 (Bankr. M.D. Fla. 1985), *aff'd*, 86-2 U.S.T.C. (CCH) 9520 (M.D. Fla. 1986), *remanded*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S.Ct. 1724 (1988), *held not moot on remand*, 861 F.2d 1538 (11th Cir. 1989):

> "[A] Chapter 11 debtor enjoys great latitude in how and if a plan is proposed and thus how and when the IRS will be paid. . . . The debtor propounding a plan has a number of options with respect to treatment of a claim by the IRS and it is the freedom afforded by these options which dictates the conclusion that payments to the IRS pursuant to a confirmed Chapter 11 plan of reorganization are voluntary."

Accord, In re Greenberg, 105 Bankr. 691 (Bankr. M.D. Fla. 1989) (following *In re Energy Resources, et al.*).

Where, as in the present cases, funding for the plan has been provided by an outside source, the lack of coercion is particularly evident. *In re The Franklin Press*, 52 Bankr. 151 (Bankr. S.D. Fla. 1985). The outside party is not subject to the control of the bankruptcy court and cannot be required to contribute to the plan. *Id.* Payments made with funds supplied or arranged by a third party can only be held to be voluntary. *Id.*

A payment of federal taxes made pursuant to a Chapter 11 plan is not "involuntary" in the sense contemplated by the *Amos* and *Muntwyler* decisions. *In re Lifescape, Inc.*, 54 Bankr. at 528-29. The wide latitude afforded the Chapter 11 debtor in structuring its plan and the limited role of the court in confirming that plan demonstrate that the action of a Chapter

11 court falls far short of the coercive power of a levy, execution or judicial sale. *Id.*

The Government attempts to shift the focus in this analysis from the rehabilitative purpose of Chapter 11 to the responsibilities imposed on a debtor by the Bankruptcy Code. The Government relies on three recent circuit court decisions, *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987), *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987), and *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988). Respondents maintain that the *Ribs-R-Us* and *DuCharmes* decisions are incorrect and the *Technical Knockout Graphics* case is both incorrect and distinguishable.

In *Ribs-R-Us*, the court of appeals based its decision on the narrow and pessimistic view that a Bankruptcy Code proceeding can only be regarded as a last resort by a debtor desperate for a stay of creditor action and a Chapter 11 discharge. *See* 828 F.2d at 203. The Third Circuit lost sight of the rehabilitative purpose of Chapter 11, which preserves the debtor's options other than liquidation, and it failed to distinguish between the inevitable obligation to pay taxes in bankruptcy, which it stressed, and the same inevitable obligation outside of bankruptcy, which clearly allows for designation by the taxpayer. The responsibilities to creditors placed on the debtor in possession are a reasonable exchange for the forbearance from collection action imposed on creditors; they assure that *all* creditors, not just those with the largest claims, or the greatest leverage, will be considered. In this way, the debtor's assumption of these responsibilities promotes the creditor equality that assures that its conduct under Chapter 11 *will* be voluntary. The attitude reflected in the *Lifescape* and *A & B Heating and Air Conditioning* decisions is far more consistent with the rehabilitative purpose of the Bankruptcy Code than the negative approach taken in *Ribs-R-Us*.

The Government also relies on the decision in *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987). In *Technical Knockout Graphics*, the payments at issue were not made pursuant to a plan of reorganization but were made prior to the proposal of a plan, at the debtor's request. In refusing to permit their allocation by the debtor, the court stressed what it termed "abuse" of the bankruptcy system by a designation that benefited the principals and "possibly harm[ed] other creditors" without notice to the creditors or approval of the court.

The *Technical Knockout Graphics* decision is inapplicable to the present case for two reasons. First, considerations applicable to a partial payment of a pre-petition claim outside a plan, before it is clear that there will be sufficient assets to pay claims of higher priority, and before the debtor's assets revest in it incident to confirmation of the plan (11 U.S.C. § 1141(c)), are clearly different from those concerning a confirmed plan of reorganization which provides for satisfaction of senior claims and payment of tax claims in full. Second, in *Technical Knockout Graphics* the court failed to distinguish between a taxpayer's right to allocate its tax payments and abuse of that right by a debtor. The disclosure, notice and hearing provisions surrounding a reorganization plan assure that creditors will understand the plan's provisions and may object to any harm to their interests. The potential for abuse that concerned the *Technical Knockout Graphics* court is amply addressed in the Bankruptcy Code; it is not necessary to deny *all* debtors the benefits of designation in order to guard against such abuse.

B. *The IRS's policy characterizing Chapter 11 plan payments as involuntary is not entitled to judicial deference.*

The Government's conclusion that the tax payments involved herein are not voluntary, which is the linchpin of its

position, is not entitled to judicial deference. No statute or regulation mandates the IRS's application of tax payments under a confirmed Chapter 11 reorganization plan and indeed a recent legislative effort intended to afford the IRS the power it asserts herein failed. Government Petition at 20a. The only administrative authority that the Government could point to is the bald statement that such payments are involuntary set out in § 57(13)4.3 of the Internal Revenue Manual and certain revenue rulings,[2] neither of which have the force or effect of law. As one court has aptly observed:

> "A ruling is merely the opinion of a lawyer in the agency and must be accepted as such." (citations omitted).

Stubbs, Overbeck & Associates, Inc. v. *United States*, 445 F.2d 1142, 1146-7 (5th Cir. 1971). Rulings do not even have the effect of a regulation. *Id.* The Internal Revenue Manual, likewise, because its purpose is to govern the internal procedural affairs of the IRS, does not carry the force or effect of law. *Vallone* v. *Commissioner*, 88 T.C. 794, 807 (1987).

[2]Contrary to the Government's position, IRM § 57(13)4.3, surprisingly not cited in the Government's brief, actually states that all payments received from bankruptcy proceedings shall be applied pursuant to orders of the court if such direction is given. The Government does cite four revenue rulings (Government Brief at 20), but none of these rulings involves a bankruptcy reorganization or any other judicial proceeding. Rev. Rul. 73-304, 1973-2 C.B. 42; Rev Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43; superceding Rev. Rul. 58-239, 1958-1 C.B. 94. And, none of these rulings pertains in any way to involuntary payments. Instead, the cited rulings merely state that the IRS will honor a taxpayer's designation of payments that it makes voluntarily, but that if no such designation — of voluntary payments — is made, the IRS will apply those payments either in a specified order (Rev. Rul. 73-304, Rev. Rul. 73-305, Rev. Rul. 58-239) or in some other manner serving the IRS's best interest (Rev. Rul. 79-284). The rulings do not address at all the issue of whether payments under a confirmed Chapter 11 reorganization plan are voluntary or involuntary or how such payments would be treated if they were held to be involuntary.

Indeed, even with respect to the IRS itself, "the policies and guidelines set forth in the Internal Revenue Manual are directory, not mandatory." *Timmerman et al.* v. *Swenson et al.*, 79-2 U.S. Tax Cas. (CCH) ¶9588 (D. Minn. 1979) (collecting cases). Moreover, those IRS rulings are, in large measure, irrelevant because they do not address the issue of the allocation of payments in a Chapter 11 case, where, for the reasons argued above, the nature of the taxpayer's actions is considerably different from that in the liquidation, seizure or levy context. All of the IRS's issuances are, not surprisingly, concerned only with one creditor — the IRS. As is stated in Rev. Rul. 79-284, *supra*, n.1, "[T]he Internal Revenue Service will allocate partial payments of withheld employment taxes . . . *in a manner serving [the IRS'] best interests*." (emphasis added). Of course, no internal rule of an agency can circumscribe a court's power to act or to interpret the proper application of the law. *See Dixon* v. *United States*, 381 U.S. 68, 74 (1965).

Because the First Circuit appeared to afford the IRS's position a presumption of validity (Government Petition at 12a), it fundamentally failed to decide an essential issue before it, i.e. whether or not the debtor's characterization of its payments as voluntary was within the common law rule allowing such payments to be allocated to specific debts. Government Petition at 7a-8a. Stating, as the court of appeals did, that one cannot say the IRS's view is clearly unreasonable, is simply not deciding what was a pure question of law before it under circumstances where the IRS's view was entitled to no presumption of validity in applying the facts to the common law.

The Government acknowledges that the IRS's policy is based only upon its interpretation of common law principles pertaining to debtor/creditor relations. Government Brief at 19-20. But, the IRS has no special expertise in the interpretation of such general common law principles that would entitle its inter-

pretation to judicial deference. *UPG, Inc.* v. *Edwards*, 647 F.2d 147, 156 n.23 (Temp. Emer. Ct. App. 1981) ("If the interpretation is not based on expertise in a particular field . . . but is, instead, based on general common law principles, great deference is not required."). As discussed above, the IRS's conclusion that tax payments under a confirmed Chapter 11 plan are involuntary, and its additional conclusion that the common law allows it, as creditor, to apply involuntary payments as it sees fit, rather than to follow the bankruptcy court's designation, are both wrong.

C. *Tax payments made under a confirmed Chapter 11 plan reflect the exercise of control by the debtor over its own property within the meaning of the common law.*

As addressed at length in the Amicus Brief of GLK, Inc., the voluntary-involuntary dichotomy wrestled with by the circuit courts of appeals may reflect an unintentional deviation from traditional common law principles. To the extent that is true, the essential feature justifying the right to designate the application of debt payments lies in the right of control over and ownership of the funds at the time of payment. *Orleans County Nat'l Bank* v. *Moore*, 112 N.Y. 543, 20 N.E. 357 (1889); *Bank of California* v. *Webb*. 94 N.Y. 467, 472 (1884). In that spirit, it is clear that at the time of payment in both of the Chapter 11 cases at issue here, the designated payments were made following confirmation of the reorganization plan under 11 U.S.C. § 1129, at a time when any and all property formerly of the estate was revested in the debtor (or in the case of Energy Resources its designee), 11 U.S.C. § 1141(b), free and clear of all claims and interests of creditors except as otherwise provided in the plan or the order of confirmation (11 U.S.C. § 1141(c)). In this respect, *Technical Knockout Graphics*, *supra*, again is distinguishable because at the time of

payment, in that case prior to confirmation of a plan, the payment was out of funds of the estate and not in the ordinary course of business. If, as the IRS will concede, a voluntary pre-bankruptcy payment by a troubled corporation owning and controlling the funds paid may be designated by the payor, binding the IRS, then it should logically follow that a similar payment, post-confirmation, by a now rehabilitated and financially reorganized corporation, owning and controlling the "same" funds paid against the "same" array of tax indebtedness, should be able to be designated by the payor, equally binding the IRS.

II. The Bankruptcy Court Has the Power to Designate the Application of Tax Payments Under a Confirmed Chapter 11 Plan Regardless of Whether the Payments Are Considered to Be Involuntary.

Respondents contend that it is both necessary and appropriate for this Court to determine that the designation of tax payments under confirmed Chapter 11 plans should be binding upon the IRS, whether because the payments are voluntary, within the meaning of the voluntary-involuntary dichotomy wrestled with by the recent courts of appeals decisions, or because the payments reflect traditional ownership and control indicia within the scope of the historic common law analysis. However, if this Court concludes that the payments are involuntary, or that the ownership and control of the funds is not sufficiently limited solely to the corporate t payer after confirmation of the plan, then Respondents submit for the reasons stated below that the bankruptcy court, and not the IRS, possesses the legal power to allocate the post-confirmation tax payments to the "trust fund" tax liabilities first. In this regard, the First Circuit, ac-

knowledging that there is a community of creditor interests[1] competing for limited resources in a Chapter 11 case, whose interests are better served by the debtor's rehabilitation, rather than liquidation, announced a rule that strikes an appropriate balance between the equally important Congressional goals of reorganizing a troubled enterprise and providing for the payment of federal taxes.

A. *When funds are disposed of by a court, particularly under circumstances affecting many creditors, the court has the power to order allocation of the tax payments.*

At common law, as argued at length in the Amicus Brief of GLK, Inc., it is the court which should dictate the application of funds where such funds come within the ambit of a judicial proceeding for the reason that control over and ownership of the funds more logically reside in the court, as opposed to either the party obligated on the debts affected by disposition of the funds (Energy Resources and Newport) or the party anticipating receipt of the funds (IRS). *Bank of California* v. *Webb*, *supra*; *Orleans* v. *Moore*, *supra*. As the court stated in *Webb*, "[i]f neither party makes any application of the

[1] In commenting on how Congress in general has required that in bankruptcy cases creditors sublimate their individual interests to the interests of the community of creditors, Professor Thomas H. Jackson wrote:

> "The single most fruitful way to think about bankruptcy is to see it as ameliorating a common pool problem created by a system of individual creditor remedies. Bankruptcy provides a way to override the creditors' pursuit of their own remedies and to make them work together.
>
> This approach immediately suggests several features of bankruptcy law. First such a law must usurp individual creditor remedies in order to make the claimants act in an altruistic and cooperative way. Thus, the proceeding is inherently by collective."

T. Jackson, *The Logic and Limits of Bankruptcy Law*, Harvard University Press (1986) at 16-17.

payment (when it has control over it) and the matter comes into court, then the court will make such application of the payment as equity and justice require." 94 N.Y. at 472.

Under this common law concept, therefore, even though a debtor cannot designate the application of an involuntary payment, it does not follow automatically that the creditor can unilaterally make that decision. The Government's reliance upon 60 Am. Jur. 2d *Payment* § 103 (1987) and 70 C.J.S. *Payment* § 37 (1987) is misleading and misplaced because, as the latter treatice makes clear, "(t)he application of an involuntary payment rests in the discretion of the court. . . ."

The Government's conclusion that the payments at issue here were involuntary requires it to emphasize the sentence in *Amos* v. *Commissioner*, *supra*, referring to "a legal proceeding" (47 T.C. at 69) and the alleged "considerable extent of judicial involvement in a Chapter 11 proceeding. . . ." (Government Brief at 22). However, the IRS may not have it both ways. Either it receives the funds "involuntarily" without the intervention of a judicial proceeding, and thus may make the allocation, or it benefits from the judicial involvement and control over the funds, and thus may only accept the funds with whatever allocation the court has seen fit to impose as a matter of equity.

Amos v. *Commissioner*, *supra*, is not only consistent with the foregoing general rule but it and several recent decisions even bolster the conclusion that when there is judicial involvement in the disposition of the funds sought to be allocated, particularly where other creditors are involved, the court has the power to allocate if it seeks to act. In *Amos* the Tax Court specifically pointed out — the first of two important caveats to its holding — that the recipient's ability to allocate involuntary payments may *not* be available at all when the interests of other creditors are affected by the allocation sought to be made by the IRS, stating:

> "We expressly refrain from deciding whether the same right of application governs where the rights of other creditors may be adversely affected. Cf. *Commercial Credit Corporation* v. *Schwartz*, 130 F. Supp. 524 (E.D. Ark. 1955)."

Amos at 70, n.5. Thus, in those Chapter 11 cases where, in accordance with the test applied by the First Circuit, the interests of other creditors are affected by the allocation issue, the general rule in *Amos* is inapplicable. What the *Amos* court recognized is that the inquiry should not end and a ruling mechanically follow even when a payment may be found to be "involuntary." Instead, that court observed that where the interests of other creditors are implicated by the allocation issue, a court must consider the interests of those affected creditors.

This caveat to the holding of *Amos* is one that has long been followed by courts. Even where the payment is "involuntary," where the interests of other creditors are affected by the manner in which payments to one creditor are allocated and a court has control over the money to be paid (or from which the payment is to be made), then it is within the power of a court to direct an allocation of payment. In doing so, a court must follow basic principles of equity, seeking to protect the rights of all parties. *United States* v. *Transamerica Insurance Company*, 357 F. Supp. 743, 748 (E.D. Va. 1973) (collecting cases).

In *Transamerica*, the United States sought to apply a payment of approximately $31,000, designated by the debtor to be applied to back rent for the year 1963, instead to back rent for 1967 and 1968. The defendant in the case had issued a surety bond to cover unpaid rent only for 1963 and the United States, of course, hoped by applying the funds to the later years to hold the solvent surety liable on the 1963 back rent, thereby maximizing its total collection of funds owed by the

debtor. Although the court found that the payment was "involuntary," it refused to allow the Government to allocate the payment, stating, "This finding [of involuntariness] does not result, however, in a conclusion that the United States was free to apply the sum as it chose. To the contrary . . . the duty falls upon (the court) to do so." 357 F. Supp. at 748. The court was unable to decide on the record before it how the payment should be allocated because there was insufficient evidence to determine how other creditors would be affected by the allocation and left that issue to trial.

Similarly, in *First National City Bank* v. *Kline*, 439 F. Supp. 726, 729 (S.D. N.Y. 1977), the court held that:

> "Where, as here, moneys are repaid under judicial order, the court has exclusive authority to apply the funds and its application must be structured as 'equity and justice require'." (citations omitted).

Likewise, in *Commercial Credit Corp.* v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D. Ark. 1955), cited by the Tax Court in *Amos* in announcing one of the caveats to its general rule, the court, in the exercise of its equitable powers, set aside an allocation of payment (which was clearly "involuntary") the IRS wished to make because that allocation would have been inequitable to other creditors seeking to obtain some satisfaction of their claims from the same property that was subject to the IRS claims. Although the IRS insisted that its allocation was legal and proper, 130 F. Supp. at 529, the court set it aside because it was inequitable to other creditors. *Id.* at 530.

The three cases cited above, *Transamerica Insurance Company*, *First National City Bank* and *Commercial Credit Corp.*, all uphold the proposition that when a court controls or supervises the money or other property from which a payment is to be made, then, even if the payment is "involuntary," it is for

the court, not the creditor, to decide how the payment will be applied, and the court will apply the payment equitably. In fact in *Amos* itself, the Tax Court, implicitly recognizing this rule, indicated — its second caveat — that a creditor's right to apply an "involuntary" payment has no application in a bankruptcy case where property is under a court's supervision. It stated:

> "Usually cases applying this rule [that even "involuntary" payments may not be applied in the manner in which the creditor unilaterally decides] involve judicial proceedings, such as *bankruptcy*, receivership, probate, or mortgage and lien foreclosures, in which sale of the property is under the umbrella of the court's supervision. *In such situations, the court, in its discretion, determines the application of payments according to legal and equitable principles.*" (emphasis added).

47 T.C. at 68 n. 3.

Clearly, the rule that emerges from *Amos* does not aid the Government in the context of a Chapter 11 case where the interests of other creditors may be affected by the allocation issue, and where a bankruptcy court, arguably, has supervisory (and ultimate) control over a debtor's property from which payments to the IRS are to be made. In the final line in the above quotation from *Amos*, the Tax Court distinguished the situation (and rule that emerges) where a court has supervision over the property from which a payment is to be made from that immediately before it where a court had no such supervision or control, stating:

> "There is no supervision or control over payments received by a district director as a result of administrative collection of Federal taxes by levy or distraint."

Id. In *Amos*, the Tax Court concluded, correctly, that the IRS could, in the absence of court control or supervision over the property that was subject to its levies, apply the proceeds from the execution of those levies as it saw fit. Its ruling is limited to the facts before it, which are readily distinguishable from those in a Chapter 11 case.

B. *Bankruptcy courts in particular have the statutory power to order allocation of the tax payments.*

Bankruptcy courts have long been considered courts of equity, *Pepper* v. *Litton*, 308 U.S. 295, 304-05 (1939); *United States Bank* v. *Chase Bank*, 331 U.S. 28, 36 (1947); *Katchen* v. *Landy*, 382 U.S. 323, 327 (1966), and Congress has granted bankruptcy courts broad equitable powers, including those powers "expressly or by necessary implication conferred by Congress." *Johnson* v. *First Nat'l Bank*, 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984). Specific authority for the exercise of equitable powers by bankruptcy courts is found in 11 U.S.C. § 105, which provides that such courts "may" issue any order, process or judgment that is necessary *or appropriate* to carry out the provisions of this title [the Bankruptcy Code]" (emphasis added). The First Circuit correctly found that "at least on some occasions," exercise of a bankruptcy court's equitable power to allocate payments under the limited circumstances[4] it outlined would be "appropriate" (Government's Petition at 13a) since, under the court's

[4] It is noteworthy, and should ameliorate any concern the Government has that the debtor's allocation of tax payments will be "routinely" allowed, that the bankruptcy court which fashioned the approach the First Circuit generally adopted, *In re B & P Enterprises, Inc.*, 67 Bankr. 179, 183 (Bankr. W.D. Tenn. 1986), (Government Petition at 21a), found under the facts and circumstances of that case that the plan proponent would *not* be permitted to designate payments to the IRS.

test, such power is to be invoked only where it will further the central and overriding purpose of Chapter 11 — the rehabilitation of the debtor — with, at the same time, due deference to the importance of paying federal tax claims. *Accord*, *Matter of A&B Heating and Air Conditioning*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, 108 S.Ct. 1724 (1988), *held not moot on remand*, 861 F.2d 1538 (11th Cir. 1989); *see Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197 (1988) (equitable powers of bankruptcy courts "must and can only be exercised within the confines of the Bankruptcy Code.")

The Government contends that allowing allocation of tax payments is beyond the scope of a court's power under § 105, that bankruptcy courts are not "roving courts of equity" and that such a ruling would not be in step with the generally recognized proposition that § 105 neither authorizes bankruptcy courts to create substantive rights that do not exist under state law or otherwise enter orders contrary to the express provisions of the Bankruptcy Code ("Code"). Respondents submit that this case crosses none of these boundaries. The cases cited by the Government in support of these propositions are vastly different than the case now before the Court because they address areas where the lower courts used § 105 to craft a result contrary to the intended import of specific statutory provisions. In *United States* v. *Sutton*, 786 F.2d 1305 (5th Cir. 1986), the lower court held that under § 105 a trustee had the authority to pay support to a debtor's wife and children. The district court reversed and the circuit court affirmed the district court, finding that the distributions were not justifiable as compensation for services rendered to the estate, and thus did not qualify as administrative expenses. Moreover, the distributions did not fall within the scope of the Code provisions expressly enacted to address a debtor's support obligations. In *In re NWFX, Inc.*, 864 F.2d 593 (8th Cir. 1989), the court of appeals reversed a lower court's ruling allowing setoff even

in the absence of mutuality of debt, finding that the court's reliance on § 105 to fashion an equitable right to setoff broader than that contained in the Code (11 U.S.C. § 553) was improper because it created new substantive rights inconsistent with those in the Code. In *Official Committee of Equity Holders* v. *Mabey*, 832 F.2d 299 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988), the district court authorized the debtor to set up an emergency treatment fund for individuals adversely affected by the debtor's product. The court of appeals reversed the district court, holding that the fund violated the clear policy and intent of the Code preventing piecemeal payment to unsecured creditors except under a properly presented and approved plan of reorganization.

Allocation of tax payments requires neither the creation of new substantive rights nor the violation of the provisions and policies expressed in the Code. It is therefore well within the scope of the powers available to the court under § 105 and logically is but an adjunct to the exercise of power under several provision of the Code which address the treatment of tax claims. See, for example, 11 U.S.C. § 507(a)(7) providing for the priority payment of tax claims, 11 U.S.C. § 1129(a)(7) providing for the possible payment of tax claims over a six-year period, and 11 U.S.C. § 505 providing for determination of the amount of tax claims. A court order concerning the proper allocation of tax payments is a logical carrying out of these provisions, particularly § 505 because such an order will dictate which components of the IRS's claim are being paid with what dollars.

The Government suggests that the equitable powers conferred on the bankruptcy court under § 105 are narrowly limited to the issuance of orders such as injunctions or contempt findings where such orders are necessary to implement the clear substantive provisions enacted by Congress. In so arguing, the Government ignores the fact that there are many other types of equitable powers that bankruptcy courts have traditionally

exercised although such powers are not found in the strict four corners of the Bankruptcy Code. *See, e.g., In re Morahan*, 53 Bankr. 489 (D.Me. 1985) and *In re Ann Arbor Brewing Co.*, 110 F. Supp. 111, 116 (E.D. Mich. 1951), in which the courts applied the equitable doctrine of marshalling to adjudicate rights of competing lienholders; *Browning* v. *Navarro*, 887 F.2d 553, 559 (5th Cir. 1989), where the court, recognizing that bankruptcy courts are in the business of allowing and disallowing claims, found that voiding a state court judgment on grounds that it was fraudulently obtained is within the ambit of § 105; *In re Ranch House of Orange-Brevard, Inc.*, 773 F.2d 1166, 1169 (11th Cir. 1985), where the court stated that a bankruptcy court has the power to employ the equitable doctrines of waiver and estoppel in adjudicating the rights of parties to an expired lease.

The First Circuit fashioned the following test in this case to determine under what circumstances tax payments may be allocated:

> ". . . upon consideration of the reorganization plan as a whole, insofar as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, i.e., increased likelihood of payment to creditors who might otherwise lose their money?
>
> * * *
>
> In applying this test, of course, the bankruptcy court must recognize the obvious importance of satisfying tax liabilities. . . ." (Government Petition at 21a).

That test is very similar, in its focus, to the test this Court set forth in *N.L.R.B.* v. *Bildisco and Bildisco*, 465 U.S. 513

(1984),[5] in which one important national goal, preserving the rights of workers under collective bargaining agreements, converged with the overarching goal of Chapter 11 — the successful rehabilitation of debtors. There this Court stated:

> "Since the policy of Chapter 11 is to permit successful rehabilitation of debtors, rejection [of collective bargaining agreements] should not be permitted without a finding that that policy would be served by such action.
>
> * * *
>
> Determining what would constitute a successful rehabilitation involves balancing the interests of the affected parties — the debtor, creditors and employees. The Bankruptcy Court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them . . .
>
> * * *
>
> The Bankruptcy Court is a court of equity, and in making this determination it is in a very real sense balancing the equities . . . Nevertheless, the Bankruptcy Court must focus on the ultimate good of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization." At 527.

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[5] Although there was a dissenting opinion in *Bildisco*, there was unanimity concerning the appropriateness of this test, as the dissenting justices agreed that it properly accommodated the policies of the National Labor Relations Act and the Bankruptcy Code. 465 U.S. at 535.

As this Court was in *Bildisco*, the First Circuit was concerned about furthering the overriding policy of Chapter 11. It fashioned an equitable test that was calculated to do so, while at the same time respecting an important competing policy goal involving the collection of tax revenues.

C. *The IRS's position is at odds with its own policy deferring to judicial direction.*

The Government's opposition to the court ordered designations involved herein violates that agency's own internal rules. Those rules are set out in § 57(13)4.3 of the Internal Revenue Manual, which states without analysis or explanation the IRS's view that tax payments arising in a bankruptcy proceeding "are considered involuntary." Sec. 57(13)4.3(1). Significantly, however, the Manual also states that such "*[p]ayments received from [bankruptcy] proceedings should be applied as set out in the court order*, or, if no such direction is given, the money should be credited in such a manner as to give maximum benefit to the United States insofar as future collections are probable." *Id.* (emphasis added); *see also* IRM § 57(13)5.4(4). While the Manual does lay out a hierarchy for the application of payments (with trust fund taxes in the fourth of five categories), the Manual is explicit that that hierarchy applies only "*[t]o the extent it is consistent with any applicable [court] order*." *Id.* In other words, even under the IRS's own rules, it claims to have blanket authority to apply tax payments such as those involved herein as it see fit only "if no [contrary] direction is given" by the bankruptcy court. *Id.* This is precisely the position the IRS appeared to have taken in the Energy Resources case when it rejected the trustee's check and informed him by letter that "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment . . . to its maximum benefit." Government Brief at 4. The Government has offered no explanation as to why the IRS should be free to ignore its own rules and/or policies in this case.

D. *The First Circuit's test represents an appropriate balancing of two equally important national goals that converge in Chapter 11 cases.*

The Government misinterprets the law and overstates its case in arguing that "there is a 'clear policy judgment by Congress' favoring collection of priority taxes over the debtor's rehabilitation." (Government Brief at 32, citing to *United States* v. *Gurwitch*, 794 F.2d 584, 585-586 (11th Cir. 1986)).[6] Neither Congress nor this Court has stated or implied that the important goal of paying federal taxes predominates over the important goal of rehabilitating and reorganizing a business enterprise. Through a series of carefully crafted Bankruptcy Code provisions, Congress has provided for a mutual coexistence of these goals. The rule announced by the First Circuit preserves the balance Congress sought to achieve and harmonizes those competing policies just as this Court has done in other bankruptcy cases where legitimate and important competing policies of national importance converged.[7]

Bankruptcy courts hold an array of powers with which, in general, to effect Congressional and long-honored judicial

[6] The Government has quoted from *Gurwitch* out of context and given a slant to it never intended by the Eleventh Circuit. What the court of appeals held there was that the personal tax obligations of the taxpayer, which he acknowledged owing and which were clearly non-dischargeable to begin with, were neither reduced nor rendered dischargeable upon the close of his case under the doctrine of res judicata or collateral estoppel by the IRS's filing of a proof of claim for an amount less than the amount he conceded was owed to it. There are two Bankruptcy Code provisions that clearly defeat the argument the taxpayer raised, which probably explains why the court's opinion is so brief.

[7] *See N.L.R.B.* v. *Bildisco and Bildisco*, *supra*, and *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198 (1983).

notions of "equity" between a debtor and its creditors and among classes of creditors. The specific adjustments in normal (i.e. non-bankruptcy) debtor-creditor relationships that occur in a bankruptcy case, from which federal tax claims are not immune, reflect Congress' desire to further one or more general policies that pervade bankruptcy law. Among those general policies is Congress' desire to encourage the reorganization of a debtor, rather than to oversee its liquidation, and thereby provide the greatest return for the greatest number of creditors.[8]

These notions of equity and collectivism find expression in many Bankruptcy Code provisions. A creditor who has received a "preferential" transfer, for example, must return the money or other property received to the debtor's bankruptcy estate because Congress has provided in 11 U.S.C. § 547 that it is simply fair and equitable to all other creditors that that be done. This is so even though as between that creditor and the debtor it may have had a legitimate right to retain that money or other property and could have done so but for the subsequent filing of a bankruptcy petition. Congress has also, for example, severely limited the amount of otherwise valid lease or employment termination claims under 11 U.S.C. § 502(b)(6) and (7) respectively in order to increase the likelihood of other general unsecured creditors receiving a dividend in the case.[9] It has provided through 11 U.S.C. §§ 365 and 1113 that a debtor can reject a valid executory contract, unexpired lease or collective bargaining agreement, for example, when doing so will facilitate reorganization and thereby benefit the bankruptcy estate and creditors in general. Other, uncodi-

[8] See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 220 (1977). *United States* v. *Whiting Pools, Inc.*, 462 U.S. at 527; *N.L.R.B.* v. *Bildisco and Bildisco*, 465 U.S. at 203; *Pension Benefit Guaranty Corp.* v. *LTV Corporation*, 875 F.2d 1008, 1016 (2d Cir. 1989).

[9] See H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 352-354 (1977); S. Rep. No. 95-989, 95th Cong., 2d Sess. 62-5 (1978).

fied principles and doctrines grounded in notions of equity, such as marshalling of assets, have been regularly applied by bankruptcy courts in order to benefit all creditors. *See, e.g., Caplinger* v. *Patty*, 398 F.2d 471, 474 (8th Cir. 1968); *In re Jack Green's Fashions for Men*, 597 F.2d 130, 133 (8th Cir. 1979).

Although federal tax claims merit important consideration in bankruptcy cases, they are by no means inviolable, as one might infer from reading the Government's brief. There are a host of Bankruptcy Code provisions that apply to reduce and otherwise affect federal tax claims and interests in precisely the same manner as claims of other creditors are adjusted and affected. Indeed, not all tax claims are afforded priority status, 11 U.S.C. § 507(a)(7), and in at least one instance Congress has rather dramatically impaired federal tax claims in bankruptcy cases while leaving equivalent non-federal tax claims entirely unimpaired.[10]

For example, just as is true of all other unsecured claims, interest ceases to run on unsecured federal tax claims during a bankruptcy case. *See* 11 U.S.C. § 502(b)(2); *In re Reich*, 66 Bankr. 554, 557 (Bankr. D. Colo. 1986) and *In re Brent Explorations, Inc.*, 91 Bankr. 104, 110 (Bankr. D. Colo. 1988). Penalties on federal tax claims are specifically subordinated to general unsecured claims, 11 U.S.C. § 726(a)(4), in order to, in fairness, permit general unsecured creditors to receive a greater return on their claims; and otherwise valid liens securing the payment of such penalties are voidable, 11

[10] Bankruptcy Code § 724(b), 11 U.S.C. § 724(b), has the effect of abrogating a valid federal tax lien by making the property subject to that lien available first for the satisfaction of administrative expenses, wage claims, consumer creditors and other claims under § 507(a)(1)-(6). See also, *In re K.C. Machine & Tool Company*, 816 F.2d 238, 244 (6th Cir. 1987). Such claims generally are not permitted to be paid from property that is subject to a non-tax secured interest, see 11 U.S.C. § 725, but are payable at the expense of the IRS from a federal tax lien.

U.S.C. § 724(a). Completely valid federal tax liens are subordinated to administrative expenses and various other claims in Chapter 7 cases. *See* n.10, *supra*. Certain federal tax claims, which may be valid and enforceable in a non-bankruptcy setting, are fully dischargeable in a bankruptcy case. *See* 11 U.S.C. § 523(a)(1)(A)&(B)[11] and *In re Gerulis*, 56 Bankr. 283, 286 (Bankr. D. Minn. 1985). Like any other creditor, the United States can be sued for and required to return to the bankruptcy estate, pre-petition tax payments and transfers made to it that are found to be preferential under 11 U.S.C. § 547. *See Drabkin* v. *District of Columbia*, 824 F.2d 1102 (D.C. Cir. 1987). Like any other creditor, the United States can be required, in the exercise of the equity powers of a bankruptcy court, to marshall its federal tax claims against the debtor in a bankruptcy case. *In re Morahan, supra*; *In re Ann Arbor Brewing Co., supra*. *See also United States Fidelity & Guaranty Company* v. *Long*, 214 F.Supp. 307, 319 (D. Or. 1963) (". . . in the application of the [marshalling] doctrine, the United States and, accordingly its agencies, are on an equal basis with other creditors"). The United States, like any other creditor, can be required by the bankruptcy court to turn over to the debtor and bankruptcy estate property which the IRS seized and controlled before the filing of the bankruptcy petition. *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 209 (1983) ("We see no reason why a different result should obtain when the IRS is the creditor.") In large measure, as is obvious from this recitation, Congress (and where the result was not specifically codified — the courts) has determined that, in accordance with its notions of what is equitable, federal

[11] Under Bankruptcy Code § 523(a)(1)(A)&(B) various IRS claims covering periods three years before the bankruptcy petition date and longer are dischargeable even though those claims would otherwise be valid and collectible under the six year limitations period for collection of taxes in Internal Revenue Code § 6502(a).

tax claims should not be immune from the general buffeting of creditor claims and interests that takes place in bankruptcy cases in order to further important policy goals such as the reorganization of a debtor and the equitable distribution of money to the greatest number of creditors.

If the Government's view were correct that collection of federal tax claims is to take precedence over all other important goals Congress sought to achieve in bankruptcy cases, then Congress never would have enacted the provisions referred to above, and this Court, for example, would have allowed the IRS to keep the property it had seized in *Whiting Pools*, rather than direct that it be returned so the debtor could attempt to reorganize its affairs in Chapter 11. If Congress agreed with the Government's contention, it never would have allowed Chapter 11 plan proponents to pay a debtor's federal tax claims over a six year period of time, 11 U.S.C. § 1129(a)(9), but would have insisted instead that the IRS be paid in full incident to confirmation of a plan of reorganization.

The IRS objects to the test announced by the First Circuit and argues for the application of a strict *per se* rule under which an allocation of payments would *never* be permitted regardless of the circumstances of a case and how the interests of other creditors may be benefited therefrom. The Government's approach and suggested *per se* rule[12] should be rejected because it completely eliminates the opportunity to designate payments where it could be used to the advantage of the bankruptcy estate and creditors as a whole, without any significant corresponding risk to the IRS.

In its opinion, the court of appeals provided one example of how designation of payment can further the reorganization

[12] As the First Circuit noted (Government Petition at 20a), the *per se* rule suggested by the Petitioner was contained in a bill proposed in the House of Representatives, see H.R. 3984, 100th Cong., 2d Sess. § 201 (1988) (proposing an amendment to § 505 of the Bankruptcy Code), which was not enacted into law.

of a debtor, and thereby result in a greater distribution to all creditors (Government Petition at 13a-14a). In that example, third parties that included "responsible persons" under Internal Revenue Code § 6672, were willing to infuse enough money to rehabilitate the debtor corporation only if the bankruptcy court would assure them that under the plan of reorganization the reorganized company would pay its "trust fund" obligations first. Without that assurance, the "responsible persons" might well prefer the conversion of the case to Chapter 7 (liquidation) under which all priority tax debts (trust fund and non-trust fund) would be paid in full,[13] thereby relieving them of any liability under § 6672, but, at the same time, perhaps eliminating altogether any prospect for the general unsecured creditors receiving anything.[14] This is but one situation where the facts are such that the designation issue directly affects a debtor's rehabilitation and the interests of other creditors. Another example is where "responsible persons" who control the affairs of a corporate debtor and have either valid or contested claims against the debtor corporation might agree to reduce or eliminate those claims in exchange for the designation of plan payments to the IRS, thereby promoting a plan and increasing the dividend to other creditors; and, still another example is where they have (as such persons within a closely-held corporation often do) the special technical expertise that is essential to operate the affairs of the corporation and are persuaded (whether in the context of third party funding or otherwise) to continue in the business and assist in its rehabilitation, rather than converting the case to Chapter 7, provided payments under a plan of reorganization are so designated.

[13] Trust fund and non-trust fund taxes have the same priority for payment under Chapter 7,11 U.S.C. § 507(a)(7). Such obligations must be paid in full under the "absolute priority" rule of Chapter 7 before unsecured creditors, who have a lower priority, 11 U.S.C. § 726(a)(2), receive any payment.

[14] General unsecured creditors in a Chapter 11 case must receive at least as much in that case as they would have received in a Chapter 7 liquidation case, 11 U.S.C. § 1129(a)(7)(A)(ii); as a practical matter, they always receive significantly more because of their bargaining position and the preservation of going concern value. In addition, in Chapter 11 such creditors generally receive payments contemporaneously with taxing authorities holding priority claims, while in a Chapter 7 case they must wait until all assets have been liquidated and such priority claims paid in full before remaining funds, if any, can be paid to them.

E. *The test announced by the First Circuit does not conflict with any federal statutes or Congressional policies.*

The application of the court of appeals test creates no material conflict between the Bankruptcy Code and Internal Revenue Code, nor any of its regulations. Bankruptcy Code § 1129 (a)(9)(C) merely requires that in order for a plan of reorganization to be confirmed, it must provide for full payment of those taxes found to be due and owing under the Internal Revenue Code and accorded priority status under the Bankruptcy Code. Neither the language of, nor the policies behind, 11 U.S.C. § 1129(a)(9)(C) and Internal Revenue Code § 6672 [15] are in conflict on the issue of allocation of plan payments.

The collection of trust fund taxes under § 6672 is not impaired by the First Circuit's decision, and that court properly rejected outright the IRS's contention that its ruling somehow undermines the policy behind § 6672. (Government Petition at 17a-18a). Accepting a Congressional policy that "trust fund" taxes must be collected, § 6672 always remains, both prior to, during and after the corporate Chapter 11 filing, as an alternative source of collection of trust fund taxes for the IRS. There is nothing in the court of appeals opinion, nor anything else in the law, that removes § 6672 as an alternative source

[15] There is nothing in the Internal Revenue Code concerning allocation of payments. *In re Technical Knockout Graphics, Inc.*, 68 B.R. 463, 465 (9th Cir. B.A.P. 1986).

of collection. It has been held repeatedly that a corporate debtor's paying its trust fund taxes through a plan of reorganization does not exculpate "responsible persons" from their liability under § 6672 or permit them or their corporation to legally restrain the IRS from pursuing collection activities against them for whatever trust fund taxes are then owed. *See* Internal Revenue Code § 7421 ("Anti-Injunction Act"); *United States* v. *Huckabee Auto Co.*, 783 F.2d 1546 (11th Cir. 1986). This is a point that seemingly was overlooked in the three courts of appeals decisions which the Government asks this Court to follow. See *In re Ribs-R-Us, Inc.*, *supra*; *In re Technical Knockout Graphics, Inc.*, *supra* and *In re DuCharmes & Co.*, *supra*. In short, as the First Circuit observed, there is "nothing, including our opinion today" that in any way inhibits the IRS from proceeding against responsible persons under § 6672 as long as there are trust fund taxes owed. (Government Petition at 20a).

In objecting to the debtor's designation of plan payments, the IRS is not concerned about collection of trust fund taxes, but collection of taxes in total. It complains about the payment of taxes being subjected to the risk[16] of a plan failure, yet Congress has specifically provided that taxes can be subjected to such a risk by enacting Bankruptcy Code § 1129(a)(9)(C), which allows federal taxes to be paid out over a six-year period under a plan of reorganization. By advocating a *per se* rule under which plan payments would always be applied first to non-trust fund obligations, the IRS seeks to insulate non-trust

[16] The risks of plan failure the IRS refers to must be considered in light of the strict feasibility requirements that must be satisfied before a bankruptcy court will confirm a plan of reorganization and thereby let a debtor leave the "safe harbor" of Chapter 11. It is and should be difficult to meet the feasibility requirements of 11 U.S.C. § 1129(a)(11), as is demonstrated in the following cases, among many, where the courts were not persuaded and refused to confirm a proposed plan. *In re Clarkson*, 767 F.2d 417, 419-20 (8th Cir. 1985) and *In re Merrimack Valley Oil Co., Inc.*, 32 Bankr. 485, 487-91 (Bankr. D. Mass. 1983).

fund claims from the same risks that all other creditors with claims of like stature face under a Chapter 11 plan. The office of § 6672 is to provide for the collection of trust fund taxes, not all taxes. The IRS is attempting to use § 6672 to render the "responsible person" a guarantor of a debtor's *entire* tax obligation. By forcing the "responsible person" to be liable for the *last* tax dollars due from a debtor, the IRS is trying to extend a responsible person's liability to income, excise, and all other non-trust fund taxes, for which Congress never intended him to be personally liable. Indeed, the Government's argument is disingenuous because it permits a voluntary payment immediately prior to bankruptcy to be allocated to trust fund taxes regardless of how insolvent the corporate taxpayer may be. If anything, its argument is really one as to why *no* taxpayer should ever be permitted to designate allocation of a partial payment, a result which it not only has unequivocally failed to press under the common law but as to which its proper remedy lies in legislative change which it has yet to achieve.

Moreover, Congress could never have intended that the IRS would use § 6672 in such a way as to be given a right, which no other creditor has, to reduce, and, as periodically-made plan payments total the amount of the non-trust fund obligations, eliminate altogether the risk of non-payment of non-trust fund taxes under a plan. Through § 6672, Congress evidenced its great concern that trust fund taxes, not non-trust fund taxes, be paid, and that § 6672 be used toward that end, rather than "stood on its head", as the court of appeals observed (Government Petition at 18a), by elevating non-trust fund taxes to a super priority position over other claims.

In addition, not only is the IRS's policy of applying plan payments first to non-trust fund taxes inconsistent with the concern Congress has expressed for the collection of trust fund taxes, it is also completely at odds with another IRS policy, that § 6672 will be used "*only* when all other means of securing

the delinquent [trust fund] taxes have been exhausted."[17] *United States* v. *Sotelo*, 436 U.S. at 279-80, n. 12. That policy cannot be squared at all with the questionable policy of the IRS, in reliance on § 6672, intentionally to pass-up early plan payments of trust fund taxes, in favor of non-trust fund taxes.

[17] Although liability under § 6672 is often colloquially referred to as the "100% penalty," § 6672 does *not* impose a penalty, *United States* v. *Sotelo*, 436 U.S. 268 (1978), but is merely a tax collection tool, *Reid* v. *United States*, 558 F. Supp. 686, 688 (N.D. Miss. 1983), used to collect taxes against one who may have had no fraudulent or bad intent whatsoever, e.g. *McCarty* v. *United States*, 437 F.2d 961 (Ct. Cls. 1971), but who, faced with an unenviable Hobson's choice of (i) not paying employees or trade creditors, and thereby watching a salvageable business fold, or (ii) not paying the IRS with the hope that there will be money to pay taxes in the future, decides to pay employees and trade creditors. While such a decision renders one liable under § 6672, it hardly carries with it the moral opprobrium the Government seeks to ascribe to responsible persons.

Respondents do not in any way denigrate the seriousness of liability under § 6672, but must point out that the Government's contention that responsible persons have *actually* collected and withheld (Government Brief at 15) the taxes they may potentially be liable for under § 6672, and then "plundered" (Government Brief at 16) an *actual* fund of money held in trust and converted such monies for their "private use" (Government Brief at 15) is out of step with reality. As a review of a sampling of the legion of "100% penalty" cases would readily show, in the vast majority of cases the money to be withheld from payroll checks was simply never available and the corporate employer made a "net payroll." In addition, contrary to the tone of the IRS's brief, responsible persons are clearly not "getting away with something" when trust fund taxes are repaid by or on behalf of an employer who is the primary obligor of such taxes.

Conclusion

For the foregoing reasons, the opinion of the First Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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